

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Haynes Analyst: LuAnna Hass Bill Number: SB 366

Related Bills: See Prior Analysis Telephone: 845-7478 Amended Date: July 10, 2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Taxpayer Bill of Rights/No Levy May be Made on Principal Residence of Innocent Investor/Release of Certain State Tax Liens

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended June 4, 2001.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED June 4, 2001, STILL APPLIES.

OTHER - See comments below.

SUMMARY

Under this bill, when an investor in an abusive tax shelter substantiates their innocence, the Franchise Tax Board (FTB) would be:

- prohibited from seizing and selling (levying) the principal residence if the reason for the levy is the underpayment of any tax attributable to an abusive tax shelter.
- required to release the proceeds from the sale or other transaction related to the levying of a principal residence.
- required to release any state tax lien, including liens that survive the bankruptcy of an innocent investor, if the reason for the lien is any underpayment of tax.
- required to return any proceeds from the sale of a principal residence that were received in satisfaction of a state tax lien or as a result of a levy.

SUMMARY OF AMENDMENTS

The July 10, 2001, amendments removed the bill's provisions, which related to liens and levies of innocent partners, and replaced them with the provisions discussed in this analysis. Specifically, the amendments would:

- Define "abusive tax shelter" as a potentially abusive tax shelter within the meaning of the Internal Revenue Code, where a penalty has been imposed by either the Internal Revenue Service (IRS) or FTB for either 1) promoting an abusive tax shelter, or 2) aiding and abetting an understatement of tax liability.

Board Position:

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Legislative Director

Date

Brian Putler

08/03/01

- Define “innocent investor” as any individual, spouse, or former spouse of that individual, that:
 - 1) Is liable for underpayment of any tax under the Personal Income Tax Law that is attributable to ownership of an interest in an abusive tax shelter,
 - 2) Had no responsibility for the creation, promotion, operation, management, or control of the abusive tax shelter,
 - 3) Did not know that the entity, plan, or arrangement would be an abusive tax shelter for the tax years to which there is an underpayment of tax as described above.
- Define “principal residence” to include any property that qualifies as a declared homestead under current state law.
- Provide that notification required by this bill must be made in the manner FTB prescribes.
- Prevent FTB from seizing and selling (levying) a personal residence of an innocent investor if the residence is owned by the investor and the levy is a result of an underpayment of income tax due to an abusive tax shelter.
- Require FTB to release any state tax lien on the principal residence of an innocent investor. The release would apply to state tax liens that survive after an innocent investor is discharged from personal liability for the unpaid state tax debt in bankruptcy proceedings. The investor must own the principal residence and an underpayment of tax must be the basis for the lien.
- Require FTB to return the proceeds from the sale of a principal residence that were received in satisfaction of a state tax lien or as a result of a levy.

The July 10 amendments resolved the department’s implementation concerns and a policy concern as discussed in the department’s analysis of the bill as amended June 4, 2001. As a result of the July 10 amendments, the department has identified additional implementation and policy concerns. A new revenue estimate and all remaining concerns are included below for convenience. The remainder of the department’s analysis of the bill as amended June 4, 2001, still applies.

POSITION

Pending.

IMPLEMENTATION CONSIDERATION

The bill prohibits FTB from levying a principal residence and requires FTB to release tax liens on the principal residence upon substantiation of the innocence of the investor, but does not provide investors a timeframe in which the investor should notify FTB of their potential innocence. Failure to clearly outline a notification process for the taxpayers may cause confusion for both the taxpayer and the department and may hinder the relief allowed under this bill. The author may wish to amend the bill to make the levy prohibition and lien release provisions conditional on establishment of the “innocence” of the taxpayer prior to the department’s satisfaction of the levy or lien.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses as shown in the following table:

Estimated Revenue Impact of SB 366 As Amended 7/10/01 [\$ In Millions]			
	2001-02	2002-03	2003-04
Innocent investors and refund of levy/lien amounts	minor loss	potentially significant *	

Minor loss is less than \$500,000.

* For these issues, "significant" means combined losses on the order of \$5 million annually.

A provision added in this amendment would require the FTB to return any proceeds ever collected from the sale of a personal residence by either levy or the satisfaction of a lien if an innocent investor provided substantiation as specified.

Revenue Discussion

The revenue impact of this bill would be determined by (1) the amount of foregone collections that would otherwise have resulted from state tax liens recorded on an innocent investor's principal residence or escrow or other accounts holding proceeds from the sale of such residence, and (2) the refund of amounts the FTB has previously collected from the sale of an innocent investor's principal residence by either levy or the satisfaction of a lien.

Circumstances placing a taxpayer in the position of an "innocent investor," as defined, would appear to be rather limited. However, the bill would eliminate a collection tool in these circumstances. When no other means of collection exists, a lien attaching to a principal residence secures the unresolved tax debt. In addition, a tax lien recorded before a bankruptcy petition is filed would survive a bankruptcy proceeding. Under these circumstances, a lien becomes the only means of securing a tax debt.

The department is currently holding (pending final federal determination) approximately 400 assessments issued to about 100 investors in partnerships who were California residents. Assessed taxes average approximately \$3,000 per tax year and four tax years per investor (total of \$12,000). Tax years at issue range from 1975 through 1994 with accrued interest increasing amounts due substantially. Each of these partners would fall into the innocent investor category of this bill.

If, in any given year, the total number of innocent investor liens for all relevant cases for which bankruptcy proceedings have been completed were 25, the amount of tax and interest potentially at risk would be around one-half million dollars (assuming an average balance due of \$25,000).

This bill would extend the innocent investor relief to individuals who are shareholders in other entities such as S corporations that invest in abusive tax shelters. An innocent investor also could include beneficiaries or trustees that have participated in fraudulent tax evasion schemes that are packaged as legitimate trusts, although it is unlikely many of these investors would meet the "did not know" criteria suggested in the amendment. The IRS estimates the federal government is losing billions of dollars of tax revenue from these fraudulent tax evasion schemes that are packaged as legitimate trusts. The IRS further indicates that a large percentage of these elaborate tax schemes to conceal income and create false business expenses for investors are becoming more common in Northern California. To the extent these investors would fall into the innocent investor category of this bill, foregone collections of tax revenue would increase significantly.

It is common for FTB to receive a payment due to a demand for satisfying a lien on a taxpayer's principal residence. To the extent any of these taxpayers meet the innocent investor criteria of this bill and apply for a return of such proceeds, returns of previously collected amounts would result.

ARGUMENTS/POLICY CONCERNS

Existing Concerns:

Current laws and FTB practices, on a case-by-case basis, would provide tax relief to "Hoyt"-like taxpayers experiencing financial hardship and free their personal residence from levy and liens. Some may argue that current law and practice are sufficient to protect any of these "Hoyt" taxpayers who are truly "innocent partners."

Many taxpayers that are not investors in abusive tax shelter partnerships experience devastating financial hardships. The intent of this bill is to offer tax collection protections to these certain partners beyond those given to other similarly situated taxpayers.

This bill would allow proceeds from a sale of the principal residence, regardless of the amount of the proceeds, to escape a recorded state tax lien. This policy would be in conflict with the law that allows liens to be released only if the release will not endanger or jeopardize the collection of taxes.

There have been several recent efforts at the federal level to discourage corporations from investing in abusive tax shelters. These efforts have included regulatory action by the Treasury Department and the introduction of proposed federal legislation. While such legislation has not been enacted, this bill would move in the opposite direction by creating the possibility that taxpayers who invest in some of the most aggressive shelters may ultimately avoid paying the correct amount of tax.

New Concern:

This bill requires FTB to return any proceeds from a sale of a principal residence that were received in satisfaction of a state tax lien or as a result of a levy when an investor substantiates their innocence. Since the funds to be returned are not an overpayment, current law does not contain a statute of limitations limiting the timeframe within which an investor may request this relief. Therefore, any funds received by FTB in prior years under these circumstances could be returned to the taxpayer upon substantiation of their innocence under this bill. Returning funds of this nature that are collected in prior years could be considered a gift of public funds. The author may wish to incorporate statute of limitation language into this bill or require the investor to notify FTB of their innocence prior to satisfaction of a lien or levy.

Federal bankruptcy law allows tax liens to survive a taxpayer's bankruptcy proceeding. This bill would be inconsistent with bankruptcy law because FTB would be required to release tax liens on an innocent investor's principal residence. A lien release under these circumstances would result in a loss of a collection tool for the department and benefit other taxing agencies in other states and the IRS. That is because the federal government and other states do not have similar laws and are not required to release liens under the same circumstances.

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